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UNCLAS SECTION 01 OF 04 BRASILIA 002447

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SENSITIVE

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NSC FOR DEMPSEY
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USDOC FOR 3134/USFCS/OIO/EOLSON/DDEVITO
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E.O. 12958: N/A
TAGS: ECON EFIN EINV PREL BR
SUBJECT: BRAZIL'S ECONOMIC HIGH POINT REINFORCES LULA'S HAND

REF: A) Brasilia 2221

B) Brasilia 463
C) Sao Paulo 1328

¶1. (U) Summary: Brazil is living one of its best economic moments in recent memory. GDP growth has averaged above 6% on an annualized basis for the last three quarters. The external accounts remain healthy as exports continue to boom; Brazil should run a 1.5% of GDP current account surplus this year, its second in a row. Unemployment, while still high, has begun to fall while real incomes are beginning to rise after several years of decline. Inflationary pressures are building, however, leading the Central Bank to raise interest rates (by a quarter point) to 16.25% on September 15. The inflationary trajectory already has shifted; expected inflation in 2004 is for 7.37%, within the plus/minus 2.5 points band around the 5.5% target. Due to these dynamics, the Central Bank on September 23 announced the revision of its 2005 inflation target from 4.5% to 5.1%.

¶2. (U) Strong revenue growth means the GoB is in the unfamiliar situation of having the option of tightening fiscal policy to take some of the burden off of monetary policy, without sacrificing expenditure. The GoB announced on September 22 that it would increase the primary fiscal surplus target from 4.25% to 4.5% of GDP. It hopes that formalizing the new target will help limit interest rate increases while allowing the GoB to continue to reduce the debt-GDP-ratio. Already the debt-to-GDP ratio has fallen from 58.6% in December 2003 and may close out the year at about 55%, which would mark the first year-on-year decline in the debt-to-GDP ratio in a decade.

¶3. (SBU) Brazil took advantage of the positive situation to tap international markets with an over-subscribed Euro 750 million eight-year bond, at a spread of 477 basis points above the benchmark German Treasury note. Standard and Poor's recognized the progress by upgrading Brazil's credit rating to BB-, the same level it had before the 2002 crisis. Current low, albeit growing, investment levels mean the economy should cool off in the near term from current growth rates. But, the good economic news should strengthen President Lula's hand as he implements rigorously orthodox economic and fiscal policies and pursues structural reforms critical to boosting weak savings and investment to the levels necessary for faster economic growth. The economic news may also help candidates from Lula's Workers' Party (PT) in the October 3 nationwide municipal elections. End Summary.

The Good News

¶4. (U) The good economic news has been rolling in recently, with the Brazilian economy posting its fourth consecutive quarter of growth and the third at an annualized rate of over 6% (ref A). Analysts have been busily revising upwards their growth projections for the year: according to Central Bank survey data, the market now expects growth of 4.36% this year, and some respected analysts are predicting growth as high as 4.7%. It is not clear whether the economy has begun to cool off since the end of the second quarter. One closely-watched leading indicator, sales of packaging products, dropped over 4% in August, albeit after a July increase of over 5%. Some analysts suggest this data point meant the economy has reached an inflection point and begun to trend towards the expected 2005 growth rate of 3.5%. But other indicators from the same time frame, such as steel production, show little sign of such a cooling.

¶5. (U) Employment growth, which had lagged a bit, has now begun to pick up markedly. While unemployment is still high and remains a political issue, new GoB data show record formal employment creation in January to August (677,900 net

new jobs). The recovery is broadening across sectors, with consumption spending picking up. External accounts remain very favorable, with export growth leading to a predicted trade surplus of $30 billion and an overall current account surplus for the year of 1.2% of GDP. The weakest part of the external accounts had been Foreign Direct Investment (FDI), but after a recent uptick the Central Bank has revised its prediction of total FDI for the year from $13 billion to $17 billion.

But, Inflationary Pressure Rears its Ugly Head
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¶6. (U) Inflationary expectations, however, also have been mounting. Wholesale price pressures fed by high capacity utilization, particularly in the intermediate goods industries such as steel, have been feeding through to consumer prices. Workers are beginning to increase wage demands (such as the currently-striking bank employees) to make up for years of sliding real incomes (ref C). Companies are often acceding to union pressure and granting wage increases above inflation. Energy prices also have contributed to the mounting inflationary pressures. Accumulated inflation in the year through August clocked in at 5.14%. The market consensus as of September 17 was for consumer price inflation of 7.37% this year, substantially above the official 5.5% target, but still within the band of plus or minus 2.5 percentage points.

Balancing Monetary and Fiscal Policies

¶7. (U) Given these increasing inflationary pressures, the Central Bank on September 15 hiked the basic SELIC interest rate by a quarter percent to 16.25%. Unlike some of the previous rate decisions this year, the Central Bank telegraphed its intentions well, using the minutes of the August monetary policy meeting to lay the groundwork with the market for an increase. Public debate has shifted to how quickly and to what degree the Central Bank needs to increase interest rates to tamp down emerging inflation. The minutes of the September 14-15 Central Bank monetary policy meeting make clear that the Bank sees the September 15 hike as the first in a "process of moderate adjustment" of monetary policy, implying further interest rate increases. Increased inflationary expectations have actually reduced forward-looking real interest rates by about a percentage point since April, when the Central Bank last cut the nominal interest rate to 16%. This process of nominal adjustment would reverse some or all of that slide in real interest rates.

¶8. (U) Strong revenue growth this year has given the GoB a realistic fiscal policy option to help head off increased interest rates. On September 22 the GoB announced it had increased its primary surplus target for 2004 from 4.25% of GDP to 4.5% of GDP. Analysts argue that this should help ease the burden on monetary policy in managing inflationary expectations, allowing the Central Bank to limit the necessary interest rate increases. Notwithstanding feelings by some in President Lula's inner circle (notably Chief of Staff Jose Dirceu) that the GoB needed to dedicate part of its windfall to social and investment programs, Lula took to the airwaves September 23 to justify the decision, arguing it was better to pay down debt with the extra revenue than simply spend it. The debt-to-GDP ratio at end-year may be as low as 55%, according to some analyses, down 4.6 points on the year.

¶9. (SBU) One analyst with the Institute for Applied Economic Research (IPEA) told Econoff that the GoB really had no choice but to exceed the original 4.25% target, since revenues are running so far ahead of predictions while expenditures are ultimately capped by the 2004 budget law. (For example, last year's revisions to COFINS, a social tax paid on revenues, have brought in additional percentage point of GDP in revenues, according to the IMF ResRep; revenues also have been buoyed by the strong GDP growth. Note: The official prediction now is a total federal government revenue increase of 1.1% of GDP.) The IPEA economist opined that while the GoB might have considered trying to spend more, it would have had to obtain Congressional approval for a supplemental budgetary authorization. This, however, would put the GoB in the uncomfortable position of acknowledging that the Congress's growth and revenue predictions, which the Executive criticized in January as inflated during a sometimes acrimonious debate over cautionary spending freezes, were in fact closer to the mark than the GoB's (Ref B).

¶10. (U) Looking forward to next year, the Central Bank acknowledged in the minutes of its September 14-15 monetary policy meeting, published on September 23, that the trajectory of inflation has made unrealistic, without a sharper monetary response, the achievement of the 2005 inflation target of 4.5%. It decided to accommodate partially that inflationary inertia and announced a new 2005

inflation target of 5.1%. Subsequent to the Central Bank decision, the September IPCA-15 (a version of Brazil's consumer price index calculated on the 15th of each month, one of Brazil's rich heritage of inflation indices) clocked in at 0.49%, lower than had been anticipated.

International Markets

¶11. (U) The GoB took advantage of a favorable international market to launch on September 8 a Euro 750 million 8-year fixed-rate bond at a spread of 477 basis points over the benchmark German treasury note. The issue was oversubscribed, which allowed the GoB to increase the amount from Euro 500 million. The GoB then reopened the placement and issued a further Euro 250 million on September 22, for a total placement of Euro 1 billion. With this bond, the GoB has completed its borrowing program for the year on international markets, though some speculate the GoB will seek yet another Eurobond placement prior to year's end to increase international reserves and/or get a head start on 2005 borrowing. At both the September 8 and September 22 auctions, spreads were down markedly from the GoB's June and July issues, which were launched strategically after May and early June financial market turbulence to pave the way for private Brazilian borrowers to re-access international markets. Standard and Poor's (S&P) recognized the progress by upgrading Brazil's credit rating to BB-, the same level it had before the 2002 crisis. The move by S&P came eight days after Moody's had raised its Brazil rating to B1.

Comment

¶12. (SBU) The GoB had only the most fleeting of instants to sit back and enjoy the positive macroeconomic moment before shifting focus to combat new threats. While inflation is not out of hand and remains the lesser concern, investment, expected to hit 19% of GDP by end-year, will not bring on-stream enough capacity quickly enough to sustain growth at the current rates. Sustaining growth even at more moderate rates (3.5% to 4.5% range) will require implementation of more of the GoB structural reform agenda, including the Public-Private Partnership (PPP) legislation, bankruptcy law and reform of the judiciary. These still are pending congressional approval, with the PPP law (slated for a Senate vote after the upcoming October municipal elections) the closest to passage. Investors also would like to see a lower tax burden and more predictable (and less bureaucratic) regulatory environment, items on which it will be difficult for the GoB to make substantial progress in the short term. Still, the recession-weary public is beginning to breathe a collective sigh of relief. And, as the old adage goes, "nothing succeeds like success." Both factors should give Lula and his macroeconomic guru, FinMin Palocci, greater space to pursue their orthodox fiscal and monetary policies and the structural reform agenda.

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